DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 28, 2002

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: Pamela J. Gardiner
Acting Inspector General

SUBJECT: Office of Audit's Comments Concerning Management's Response to the "Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance" (Review # 200130039)

This memorandum presents our concerns with the Internal Revenue Service's (IRS) management response to the subject report. The response to the report was received after the final report was released.

We are concerned that the IRS plans no actions in response to two of the four recommendations in our report, and plans to take less than complete action in response to another recommendation. The data from our report, management's response, and the Office of Audit's comments follow.

Recommendations for Which the IRS Plans No Corrective Actions

Recommendation Number 3: The Commissioner should direct the Director, Organization Performance Division to develop a business results component for the Large and Mid-Size Business (LMSB) and Small Business/Self-Employed (SB/SE) Divisions' respective "Balanced Measures" that indicates the impact examinations are having on voluntary tax reporting compliance. The benefit of such an indicator is that it would assess whether the examination programs are meeting their primary objective of encouraging voluntary tax reporting compliance.

Management's Response: We disagree with this recommendation. While we concur that an accurate statistical measure of the long-term effect of examinations on voluntary compliance would be valuable to the IRS in work planning and the allocation of resources, such a measure would be difficult to implement for the following reasons:

- To track any long-term effect of an examination would require repeated examination of a select group or groups of taxpayers. We could assume that only those taxpayers that we examine would be familiar with the activity and results of the examinations, and so react by becoming more or less compliant. Measuring the long-term effect to the examination on voluntary compliance would require targeting the group for repeated examination. Such targeting would be inconsistent with our commitment to fair treatment of all taxpayers.

- Other factors, such as income level, source of income (wages, self-employment, investment), level of tax knowledge, educational level, language barriers, and ability to pay could have a significant yet unmeasurable impact on the future compliance effect of an examination. The examination and monitoring of a particular group may not have the same or any compliance impact on another group.

- Although income tax examination coverage has declined in numerical terms, we have taken steps to retain the positive influence the process has on voluntary compliance. The Examination Reengineering Project, now in progress, uses a variety of information sources to select those returns that we expect to contain errors. In addition, examinations are better oriented to areas noted for non-compliance in particular taxpayer occupations. We expect these improvements in the examination process to more effectively use our limited resources to detect tax deficiencies and foster voluntary compliance.

Office of Audit Comment: We are concerned that the IRS is not taking action to correct this vital issue. The *President's Management Agenda*[1] includes a requirement to link performance with the budgeting process. Further, the Government Performance and Results Act,[2] the General Accounting Office's *Standards for Internal Control in the Federal Government* (GAO-00-21.3.1, November 1999), and the Office of Management and Budget's *Circular A-123, Management Accountability and Control,*[3] all discuss the need to develop strategic plans, set performance goals, and report annually on actual performance compared to goals. These activities are designed to ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision-making.

The entire basis for the examination program is to encourage voluntary tax reporting compliance. Without measuring the impact tax return examinations are having on

[1] The President's Management Agenda FY 2002, Office of Management and Budget.
[2] Pub. L. No. 103-62, 107 Stat. 285 (1993).
[3] Federal Register, Vol. 60, No. 125, June 29, 1995, p. 33876 – 33882.

voluntary tax reporting compliance it is impossible to determine if budget expenditures made for those tax return examinations are contributing to the goal of improving voluntary tax reporting compliance. Therefore, taxpayers and the Congress cannot be assured that tax return examination activities they are paying for are economically and efficiently achieving the goal of improved voluntary tax reporting compliance. We recognize that an indicator may be difficult to develop, but believe the benefits will far outweigh the costs in linking performance with the budget process, and in allocating resources where they will have the most impact.

We also take issue with several of the specific points made in the response.

- The response states that tracking any long-term effect of an examination would require repeated examinations of a select group or groups of taxpayers and that such targeting would be inconsistent with the IRS' commitment to fair treatment of all taxpayers. We do not agree with these assertions. First, the IRS already targets areas of identified noncompliance, such as abusive corporate transactions and abusive trusts, and is working towards identifying other high-risk issues and groups for examination. Secondly, the fair treatment of all taxpayers by the IRS has two critical aspects. Not only does the IRS have a responsibility to treat the individual taxpayer with due process in its actions, but it also has a responsibility to the rest of the taxpayer population to ensure that each individual taxpayer pays their fair share of taxes according to the law. Thirdly, our recommendation was to look at broad classes of taxpayers and not small, specific groups. For example, the largest class of taxpayers is composed of 55 million individual income tax returns reporting less than $25,000, and the smallest group is composed of 7,800 corporate income tax returns with assets of between $100 million and $250 million in Calendar Year 2000. Lastly, to avoid repeatedly examining the same individual taxpayers within any of these classes, the IRS could use random sampling that would allow for replacing or eliminating taxpayers selected in a previous sample, or use the taxpayer's prior examination results in the current survey.

- The response states that other factors could have a significant yet immeasurable impact on the future compliance effect of an examination. If a significant portion of a class of taxpayers is found to be non-compliant, we would hope the IRS would target its resources to determine what is causing the underlying problem and use a combination of educational and compliance resources to remedy it. However, we are not convinced that it is immeasurable and that a class estimate or average could not be derived.

- The response also points out that the examination and monitoring of one particular group may not have the same or any compliance impact on another group. This was a point we brought out in our report in the discussion of the Minnesota Department of Revenue study that explained the different reactions between low and middle-income taxpayers, and high-income taxpayers. We suspect, though we have no empirical evidence to support it, that the compliance effect of income tax examinations demonstrated for low and middle-income individual income taxpayers in the Minnesota study maybe nonexistent or negative for high-income individual and business taxpayers. This has major implications in designing compliance and educational strategies for these taxpayers.

Recommendation 4: The Commissioner should direct the Director, Research, Analysis, and Statistics of Income, with assistance as needed from the LMSB Division's Director, Strategy, Research and Program Planning and the SB/SE Division's Director Strategy, Research and Performance Management, to test the feasibility of conducting an in-depth study across all income tax return classes to determine the indirect effect that income tax examinations have on amounts voluntarily reported. The study design should include information to determine taxpayer responses to issue management examinations rather than to full return examinations. This will permit the IRS to tailor examination strategies best suited for a specific income tax return class based on both the direct and indirect effects of examinations.

Management's Response: The Director, Research, Analysis, and Statistics (RAS) generally concurs with the Treasury Inspector General for Tax Administration's (TIGTA) recommendations that it would be worthwhile to conduct further studies of the indirect effects of examinations on voluntary compliance. However, for the foreseeable future, it will be very difficult, if not impossible to compare the indirect effects of taxpayer behavior from issue management examinations with full return examinations as suggested by TIGTA. Research on the indirect effects of compliance activities is still in its infancy. Furthermore, the data available in the near term will reflect traditional examinations. Sufficient data reflecting results from issue management examinations will not be available for some time.

Moreover, we cannot measure the indirect effect from any particular taxpayer contact. Instead, indirect effects can only be estimated approximately by comparing estimated variations in compliance levels over time and among broad geographic areas with variations in total IRS examination resources across the same years and regions.

Variations in compliance, in turn, cannot be directly observed. These variations can only be approximated by comparing changes in reported income and deductions from tax returns with changes in comparable measures from economic survey data. For this reason, we could only get useable estimates of the relative return to issue management examinations if we could observe differences in the level of such examinations compared with traditional examinations over a number of years and across different regions and then associate these changes with estimated changes in compliance. Obviously, this requires a sustained long-term effort to capture the relevant data for future analysis.

We believe that it would be worthwhile for RAS to update and improve estimates of indirect effects, however, we do not believe it would be worthwhile to devote large amounts of resources in the near term in an effort to develop estimates at the level of detail that available data will not support.

Office of Audit Comment: We are concerned that the IRS is not taking any corrective action. Our recommendation was to conduct a test or pilot study to assess the feasibility of a larger in-depth study of all taxpayer classes. We agree that it would not be worthwhile for the RAS to devote large amounts of resources currently to develop estimates of the indirect effect that income tax examinations have on the amounts voluntarily reported. A test or pilot study would allow researchers to identify roadblocks, work out alternative solutions, and identify data deficiencies that could be remedied with adjustments to information systems or the development of other methods to capture the information needed for a long-term effort. The response notes that sufficient data reflecting results from issue management examinations will not be available for some time. However, a pilot study could be conducted of low-income taxpayers relatively soon; preliminary data on issue management examinations for this group will be available sooner than other groups, since these examinations on average take a shorter period of time and are usually less complicated to complete.

The study by the Minnesota Department of Revenue discussed in our report showed that different classes of taxpayers behave differently in response to income tax examinations. Our concern is that scarce resources are expended where examinations actually have a negative effect on voluntary compliance. Techniques to achieve voluntary compliance may differ across taxpayer classes. This information would serve to validate behavioral aspects or characteristics of different taxpayer classes that could be used to develop the most effective compliance treatments for that class or group. We understand research on the indirect effects of compliance activities is still in its infancy, as are behavioral studies, but believe both hold great promise for designing compliance solutions that match the needs of taxpayers and the IRS, and that are economical, effective, and efficient.

Recommendation for Which the IRS Plans Less Than Complete Corrective Actions

Recommendation 1: The Commissioner should direct the Commissioners of the LMSB and SB/SE Divisions to accelerate their implementation of an examination strategy focusing on issue management, rather than the current return-based approach, for income tax examinations in their respective programs.

Management's Response: A key weakness of the IRS' current Non-Coordinated Industry Case return selection process is the inability of the Discriminate Function (DIF) to identify returns with a high potential for unreported income and to identify other specific issues with potential noncompliance. To that effect the IRS recently completed the testing of the new Unreported Income DIF formulas (UIDIF) that were designed specifically to identify returns with a high probability of unreported income. The UIDIF formulas create a new work stream for the SB/SE Division's field examination. Other changes include:

- Controlling the return classification and selection process at the national level.
- Introducing new inventory management practices and enhanced auditing procedures and techniques that will further improve the quality and timeliness of examinations.
- Expanding the Pre-Filing Agreement Program to include taxpayers in the SB/SE Division.
- Implementing objective scoring models for Industry Cases and changes to the traditional classification for LMSB Division cases.
- Reemphasizing and expanding the use of the Examination Operational Analysis Database (EOAD). This database will help gather data on issues related to industry case population and other specific issues.

Office of Audit Comment: The response describes a myriad of activities under way to move the IRS away from a return-based examination approach to an issue-based examination approach, but does not describe any actions being taken, or plans and time tables for future actions, that would accelerate the process of conversion.

While we still believe our recommendations are worthwhile, we do not intend to elevate our disagreement to the Department of the Treasury for resolution. Consequently, no further action on your part is required.

Copies of this memorandum are also being sent to the IRS managers who received a copy of the final report. Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

cc:

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